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SUBJECT: COSTA RICA AND THE FINANCIAL CRISIS: SO FAR, SO GOOD, BUT CLOUDS ON THE HORIZON

¶1. (SBU) SUMMARY: Costa Rica's conservative financial system has served it reasonably well thus far during the current global financial crisis, but 2009 will likely be difficult. The GOCR knows it must act intelligently as some fundamentals begin to deteriorate; the Arias administration does not want its final year in office to be colored only by the crisis. In the current account, the greatest worries are (1) a deterioration of exports (which grew only four percent in 2008 while imports increased 18.6 percent); (2) a slump in tourism (which hit a record two million in 2008, but has been dropping on a year-by-year monthly basis); (3) a likely drop in Foreign Direct Investment (FDI), which thus far has helped to fill some of the trade deficit; and (4) a reduction in foreign credit lines (which have begun to tighten). The drop in petroleum prices has been good news; in addition, the GOCR's countercyclical spending helped fund a USD 117.5 million liquidity package to strengthen the national banks in December, along with the "Shield Plan" announced in January to assist the disadvantaged, labor, small business, and the Central Bank. An IADB loan of USD 500 million should also help the Central Bank, but the need to fund liquidity and to make credit available on the one hand, while managing Costa Rica's high inflation rate (nearly 14 percent for 2008) on the other, is an ongoing source of economic tension. END SUMMARY.

NOT YOUR FATHER'S RECESSION

¶2. (U) In discussing prospects for the immediate future, Costa Rican experts and businessmen often refer back to the country's financial meltdown in the early 1980's. The comparisons are largely quite positive. Since then, the Costa Rican economy has benefitted greatly from globalization, with the export and banking sectors becoming more efficient and diversified. Around the region in general, consistent macroeconomic policy, self-designed rescue packages, a competitive edge with commodities, and relatively strong consumer demand positioned many economies -- including Costa Rica's -- to better weather the current storm. Such globalization also implies great vulnerability to problems originated elsewhere in the world, however, and blaming globalization for "imported" problems could again become a flash point issue for the opposition, as the body politic continues to recover from the bruising fight to institute CAFTA-DR.

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2008: MIXED RESULTS; 2009: MORE OF THE SAME?
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¶3. (U) The current picture is a mixed one, however, based on the Central Bank's monthly index of economic activity. Overall performance improved steadily in 2007 only to flatten at year's end, and then, starting in March 2008, incrementally decrease. Not surprisingly, the sectors associated with tourism and resort development declined the most. The hotel sector posted a decrease

of 3.8 percent in 2008, while construction declined 6.2 percent. Manufacturers fared the worst, with a drop of 8.4 percent. In contrast, agriculture, which tailed off in 2007, experienced a recovery in 2008. The service sector held its own in 2008 mainly as a result of outsourcing professional services from other countries. Hence, the net overall effect was a slight decline in economic activity.

¶4. (U) Economic worries continued to figure prominently in survey results. In the January 2009 CID-Gallup poll, three of ten questioned cited employment, the cost of living, and the economy in general as their key concerns. Four in ten reported the high cost of living as their biggest worry, fueled by the inflation rate, which crested at 14.4 percent in November 2008 and then eased to a year-end-rate of 13.9 percent. (For comparison, the rate in 2006 was 9.4 percent and 10.8 percent in 2007, marking an upward trend.) As for the future, noted banker Luis Liberman gloomily told the weekly financial publication "El Financiero" there would be near zero economic growth in 2009, with the current doldrums lasting up to two years. The Central Bank recently ratcheted downward its 2009 GDP growth projection to 2.2 percent. Though less negative than Liberman, the Bank offered its recent statement on lowered projections with much caution due to the uncertainty in export markets, notably to the U.S.

ARIAS HAS A PLAN

¶5. (U) In a national address on January 29, President Arias noted the "devastating dimensions" of the global financial crisis and announced the "Shield" Plan to provide social protection and a stimulus to the economy. Stressing four key beneficiaries --

families, labor, small business, and banking -- Arias outlined a program of government assistance designed to "shield" the Costa Rican economic and monetary system from worsening:

-- For families: institute measures to expand existing programs that benefit poorer families and workers. Individual pensions under a special system for disadvantaged families will be increased by 15 percent. The school-lunch program will be expanded to cover some children and members of their families during weekends, and the high school scholarship program that provides basic expenses to poor students will likewise grow incrementally. The National Training Institute will offer scholarships in coordination with companies to provide additional training to workers who would otherwise be released. In addition, the GOCR requested the state-owned banks (all of which are run by Boards of Directors) to reduce the interest rates of their smaller housing loans by two percent; one bank has officially agreed and the others are expected to follow.

-- For labor: reform the labor laws (with legislative approval) to liberalize the requirements on the number of hours per day and days per week worked. The objective is to maintain employment levels, but allow for a reduction in hours through greater work flexibility.

-- For small business: request the state banks and Banco Popular to consolidate business debt, particularly for credit-dependent organizations such as cooperatives, and to reduce interest rates by two percent for loans targeted at micro, small- and medium-sized businesses (PYMES). One bank has taken this measure and the others are expected to follow.

-- For the general economy: secure an IADB loan of USD 500 million in order to bolster the Central Bank in its role of backing the state banks. Also secure a set of loans from international institutions (para 12 below) to finance infrastructure. The Arias administration estimates that 10 percent of the monies could be spent in the next year.

HEY MR. BANKER. . . CAN YOU SPARE A LOAN?

¶6. (U) The next several months will reveal if credit tightening threatens the Costa Rica economy. Costa Rica's public banks are the

biggest in the market, largely buffered from tightening in foreign credit because they only derive about four percent of their resources from foreign sources. Private banks, on the other hand, were recently reported to derive 22 percent of their resources from overseas. One contact at Citibank told us that headquarter banks were cutting the flow of funds to subsidiaries in countries such as Costa Rica and advising subsidiaries to look to other sources for funds. Moreover, many private firms rely to one degree or the other on foreign credit lines which have disappeared or become more expensive.

¶7. (U) The public banks haven't helped matters since September 2008, when they declared that they were too close to the 10 percent equity/asset ratio required under Costa Rican law and therefore adopted the policy of only lending funds paid in from outstanding loans. Nonetheless, Alberto Dent, President of the GOCR's financial services regulator (CONASSIF), shared with us that Costa Rican banks were relatively well-capitalized, as the typical equity/asset ratio in Latin America is eight percent. With respect to loan costs, the premium above LIBOR increased from 50 basis points to 600 basis points, Dent observed, greatly raising the percentage rate charged to customers, which expands profit margins but strangles growth and results in less liquidity.

BANK SPENDING. . .THE SOLUTION?

¶8. (U) Preceding the Arias announcement of the "Shield" Plan, the GOCR injected capital into the public banks. The Legislative Assembly (legislature) quickly passed a bill in December granting USD 117.5 million to the three public banks (BNCR, BCR, BanCredito) with the explicit understanding that they would then be able to lend up to USD 1.175 billion relying on the expanded equity base. The GOCR instructed public banks to dedicate the new resources to housing and "productive" credit. The investment strategy was not written, and thus could be modified as circumstances change. The banks received these fresh resources in the last week of 2008. However, this recapitalization may be less than meets the eye, as it was made with non-coupon paying inflation-linked bonds that are not marketable. While these bonds will add to the state banks' regulatory capital, allowing more lending without violating the law,

they do not provide any actual liquidity. The banks' two percent reduction in loan rates (see para 5, above) may encourage use of those funds.

¶9. (U) A countertrend (and source of tension) to the need to create liquidity is the Central Bank's tight credit policy due to inflation. Facing the third worse inflation in Central America, a weaker currency, and falling reserves, the Bank continues to raise interest rates. President Arias' request to the state banks to lower rates will provide only very modest relief, as the benchmark "tasa basica" has risen from four percent to 11.50 percent since the currency moved off the bottom of the currency exchange band in mid ¶2008.

UNEMPLOYMENT EDGES UPWARD

¶10. (U) From 2001 through 2006, unemployment in Costa Rica was 6.0 percent or higher. During the Arias Administration, the rate fell to 4.6 percent in 2007. For 2008, the rate inched upward to 4.9 percent. The construction sector has clearly slowed down and laid off large numbers of workers in recent months as a result of a pullback in Pacific resort development. However, we are not aware of any major lay-offs outside of the construction and tourism industries. As recent as early 2008, Costa Rican officials were quite concerned with major shortfalls in labor in the construction and agricultural sectors. Both rely heavily on foreign labor, largely Nicaraguans. Now, the GOCR predicts a labor surplus, especially in northern Costa Rica, as Nicaraguans (and other foreign workers), many undocumented, flee the economic uncertainty in their own countries.

RUN UP THE DEBT; BUILD UP THE INFRASTRUCTURE

¶11. (U) In addition to a focused expansion of the money supply, the GOCR stated its determination to engage in countercyclical spending on infrastructure projects. A recent article in "El Financiero" proclaimed "The Government's New Goal is to Contract More Debt". The GOCR can reasonably aspire to do so, since Costa Rica's current external debt of USD 3&GnFOQQg programs,

external credits may have little immediate impact since there is a long lag between contract signing and project implementation. External debt is indeed low, but this year the GOCR needs to refinance a Eurobond that matures in May. Also, until very recently, the doJnLRT2\Xanging its marketing strategy: issuing short-term domestic currency and dollar-denominated securities which resulted in a much better response to its debt auctions. Nonetheless, funding for government spending will remain challenging until monetary policy is relaxed.

REAL ESTATE (AND FDI) SLOWDOWN

¶13. (U) The real estate sector, which is concentrated along the Pacific coast and which accounts for about one third of Costa Rican FDI, has suffered an abrupt reduction in activity. Due to a lack of potential buyers (largely U.S. citizens looking for vacation or retirement homes), projects have slowed or been suspended. Companies looking to invest in Costa Rica have likewise placed their decisions on hold. FDI reached USD 2.048 billion in 2008, but is highly likely to drop in 2009, according to our sources. No one is willing to predict the extent of the decline, however.

A (DOWN) TURN IN TOURISM

¶14. (U) The two-millionth tourist to Costa Rica in 2008, a member of a family of seven from New Jersey, arrived to great fanfare in the third week of December. While tourist numbers hit new records last year, however, the year-on-year monthly number has been declining since August 2008. The economic downturn in the US is mainly to blame; 54 percent of Costa Rica's tourists each year are American. The Costa Rican Institute of Tourism (ICT) is expecting 2007-2008 to show an increase of about seven percent, compared to an increase of 12 percent 2006-2007. The Costa Rican Chamber of Hotels (CCH) reports that three in ten hotels have already had cancellations for 2009 of between five and forty percent of reservations. At the opening of a new J.W. Marriott resort in the prime beach destination of Guanacaste, Marriott officials commented that the hotel occupancy rates in this region had sunk to about 25 percent.

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PETROLEUM PROGNOSIS: LOWER PRICES ARE GOOD NEWS
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¶15. (U) The recent precipitous drop in fuel prices has been a bright spot, representing major foreign-exchange savings for the country and a savings for the national budget. Statistics from 2008 indicated that, for every USD 10 drop in the petroleum price, Costa Rica spent USD 197 million less on importing the product. While Costa Rica produces most of its electricity from renewable sources (more than 80 percent), the transportation sector is completely dependent on fossil fuels, and Costa Rica has no fossil fuels production at all. CONASSIF's Alberto Dent told us that the GOCR's fuel cost planning for 2008 changed drastically from a projected USD 2.4 billion in June-July to USD 1.0 billion by the end of the year. (COMMENT: Such a drop also greatly undermines the GOCR's original stated rationale for joining Petrocaribe. Membership was still pending at the end of 2008. END COMMENT.)

COMMENT: WHAT DOES THIS ALL MEAN?

¶16. (SBU) To date, Costa Rica has weathered the crisis better than most countries, in spite of its close economic ties to the U.S. (Costa Rica's GDP is approximately $30 billion and the two-way trade relationship is valued at $8.5 billion.) Cultural conservatism and a stricter financial regulatory environment have combined to provide a natural buffer to most of the problems emanating from the ailing U.S. economy. (Financial instruments such as mortgage-backed securities and credit default swaps simply do not exist in the Costa Rican financial system.) The coming year will reveal the effectiveness of the GOCR's countercyclical spending programs, how close of a "cause and effect" relationship Costa Rica has with the U.S., and the result of the Central Bank's tight credit policy in an environment hungering for credit liberalization. Government officials, economists and most Ticos expect things to get worse, but no one is sure precisely when, and how quickly. Here as everywhere else, economics remains both a science and an art.

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